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ABSTRACT

Guarantee agencies and their financing are discussed in order to increase awareness of their role and to provide information for policy decisions. Information is provided on: the history of the Guaranteed Student Loan (GSL) program, sources and uses of funds by state guarantee agencies for fiscal years (FY) 1982 and 1984, federal advances repaid and outstanding for FY 1984, federal reinsurance of guarantee agency loan defaults, agency insurance premium policies by state, and reserves by state. It is concluded that some federal subsidies can probably be withdrawn without creating undue difficulties for state guarantee agencies, though other cutbacks would be more problematical. It is suggested that federal advance funds could be recalled if transition or alternative arrangements were made for a few (mostly new) agencies that could demonstrate real hardship from the loss of these funds. The loss of administrative cost allowances, however, especially if coupled with the recalling of advances, would create financial problems for many agencies. These problems would be exacerbated if other aspects of GSL, such as reinsurance, were also subject to revision. Several steps are suggested that might enhance the chances of finding federal cost savings without crippling the crucial functions performed by guarantee agencies in the student loan program. (SW)

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Washington Office

Student Loan Guarantee Agencies And Their Financing

A Working Paper

Janet S. Hansen and Mark L. Wolfe
Washington Office of the College Board

September 1985

College Entrance Examination Board, New York

The College Board

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FOREWORD AND SUMMARY

Student loan guarantee agencies are a key element in the credit system through which over $8 billion annually are lent to students in postsecondary education. Loans, in turn, have become the dominant form of federal student aid, dwarfing the other two "legs" in what used to be called the "three-legged stool" of student support--grants, loans, and work-study.

The size of the Guaranteed Student Loan Program (GSL) and its substantial costs to the federal government insure that it will be the subject of continuous scrutiny, especially at a time of mounting concern over the national deficit. The Washington Office of the College Board has sponsored occasional working papers intended to increase understanding of the student loan program and sharpen policy choices regarding its future. Our first such paper[1/] discussed a broad range of issues and options for the program.

This working paper concentrates on the guarantee agencies because, despite their importance, their part in the student loan scheme is not well understood. The study aims to increase awareness of the role of guarantee agencies and their financing; we also hope this study will help policy makers decide whether current arrangements can be changed without serious negative effects on student access to credit. While subsidies to guarantee agencies are a relatively small part of the federal budget for student loans, it seems likely that all phases of the program and every element of cost will be tightly scrutinized in the period ahead.

The analysis, conducted by Janet Hansen and Mark Wolfe, concludes that some federal subsidies can probably be withdrawn without creating undue difficulities for state guarantee agencies, though other cutbacks would be more problematical. The paper suggests that federal advance funds could be recalled if transition or alternative arrangements were made for a few (mostly new) agencies that could demonstrate real hardship from the loss of these funds. The loss of administrative cost allowances, however, especially if coupled with the recalling of advances, would create financial problems for many agencies. These problems would be exacerbated if other aspects of GSL, such as reinsurance, were also subject to revision.

The analysis is suggestive, rather than definitive, because of data limitations, the absence of standards or guidelines against which to evaluate important elements of the agency financing structure, and the possibility that major features of the GSL system might change at any point. The study concludes by listing several steps that might enhance the chances of finding federal cost savings without crippling the crucial functions performed by gurantee agencies in the student loan program.

1/Lawrence Gladieux, Janet Hansen, and Mark Wolfe, "Issues and Options in the Guaranteed Student Loan Program," April 1985.

A policy studies grant from the Ford Foundation helped support this analysis. We are grateful to the Foundation and to many individuals who provided information and commented on earlier versions of the report. The views expressed, however, should not be ascribed to the College Board, the Ford Foundation, or any of the individuals who reviewed and commented on earlier drafts.

Lawrence E. Gladieux
Executive Director

I. Introduction

The Guaranteed Student Loan (GSL) program, established by the federal government in the Higher Education Act of 1965, provides subsidized low-interest loans to students in postsecondary education. A companion program established in 1980, Parent Loans to Undergraduate Students (PLUS), provides educational loans to parents of undergraduates and to graduate and professional students. In FY 1984, about $7.9 billion in GSL and PLUS loans were made by about 12,000 public and private lenders, using their own capital which was guaranteed against default by the federal government and state-based guarantee agencies. About 95 percent of these loans were made under the GSL program.

The Higher Education Act included provisions enabling state and private nonprofit agencies to administer much of the GSL program. These agencies are authorized to promote the participation of lenders in the program, provide assistance to lenders to prevent defaults, monitor the enrollment and repayment status of students, and collect on loans in default. In addition, they are authorized to provide lenders with loan insurance against the default, death, disability, or bankruptcy of the borrower. In return for delivering these services, the federal government provides guarantee agencies with administrative allowances, reinsurance of loan defaults, and non-interest bearing advances to establish program reserves.[1/]

During the last several years both Congress and the Reagan Administration have been seeking ways of reducing federal spending and budget deficits. Among ideas under consideration in the student loan area is that costs to the federal government of providing loan guarantees through guarantee agencies might be reduced without eliminating necessary services or risking the willingness of some agencies to continue participating in the program. At the same time, there has been no serious discussion of the federal government taking over the direct management of the program. Rather, there appears to be a general consensus that the agencies provide better service to borrowers and lenders than could be offered directly by the federal government.

The focus of suggestions to reduce federal costs associated with guarantee agency activities has been on the payments agencies receive for administrative cost allowances and for establishing reserves against default (the so-called

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[1/] Some guarantee agencies undertake activities in addition to those specified by the federal government under GSL and PLUS; such activities might include loan servicing, direct lending, or administration of other student aid programs. This paper, however, examines state agency financing only insofar as it relates to the agencies' responsibilities for providing GSL and PLUS loan guarantees.

advance funds). Determining whether guarantee agencies can handle the reduction or elimination of federal administrative cost allowances and/or the imposition of a requirement to return advance funds would seem to hinge on an assessment of the agencies' ability to meet their operating expenses from other sources without impairing the quality of program administration and of the adequacy of the funds other than advances that they hold to cover future default obligations.

This paper attempts such an assessment by reviewing how guarantee agencies finance their activities and evaluating insofar as possible the importance of federal payments to the agencies' ability to meet their operating and loan guarantee commitments. It relies for agency financing data primarily on the Quarterly Report submitted by guarantee agencies to the U.S. Department of Education. The information on the sources and uses of agency funds contained in this report is compiled by the Department on an annual basis and is usually referred to as the "Sources and Uses of Funds Report."

The report totals each agency's sources and uses of funds by category and determines an annual excess or deficiency of sources minus uses. It also presents a figure, representing reserve funds, defined as cumulative excesses minus deficiencies since the year the agency entered into a guarantee agreement with the federal government.

Data from the Sources and Uses of Funds Report is of limited help in assessing the ability of agencies to absorb cuts in administrative cost allowances and/or in advance funds. For one example, on the operating expense side, agencies with multiple programs besides their guarantee functions inevitably exercise a certain amount of discretion in allocating operating charges against their guarantee activities, which complicates the problem of comparing operating expenses across agencies or determining the true costs of administering the guarantee program. For another, the report does not distinguish in its calculation of reserves between those set aside by guarantee agencies specifically to cover defaults and those designed to protect against unforeseen future administrative expenses or for other purposes. In addition, because agencies as a whole have not developed uniform national accounting standards for audit purposes, the data presented in the Sources and Uses of Funds Report are not necessarily comparable across agencies. Finally, there are inconsistencies and obvious inaccuracies in the data, which we have not attempted to correct, though we note them where they affect our description or analysis.

Nevertheless, the Sources and Uses of Funds Report is the only source of national data on the financing of guarantee agencies. Used with the proper cautions, it can provide some suggestive information on the reserve funds residing in agencies, on the magnitude of federal advances compared to these reserves, and on the extent to which agencies appear to have sufficient revenues to compensate for any reduction in administrative cost allowances.

After briefly reviewing the history of the GSL program, this paper describes the major sources and uses of state agency funds and examines in turn the adequacy of these funds for meeting reserve requirements and for covering administrative expenses.

II. The History of GSL

The GSL program was established by the federal government in 1965 under the authority of the Higher Education Act of 1965 (P.L.88-210). As initially enacted, the GSL program provided for the payment of interest free loans or advance funds to states to encourage the establishment of guarantee agencies to carry out the administrative and insurance functions of the GSL program. The Act also authorized agencies to charge borrowers an "insurance premium"[1/] to pay for defaults and operating costs. In addition, it established the Federal Insured Student Loan (FISL) program to provide loan insurance in areas not served by a guarantee agency.

In 1968, the Act was amended to provide for federal reinsurance at a rate of 80% of defaulted loans. The amendments also authorized the payment of additional advance funds to further encourage states to participate in the program.

By 1975, only 25 states had established guarantee agencies. Of these states, 7 had established student loan programs prior to the enactment of the Higher Education Act. Federal officials emphasized FISL rather than the creation of new state agencies; in addition, some states were unwilling or unable to assume administrative and loan insurance costs associated with the operation of the program.

In 1976, after reviewing lender and college experience with GSL and FISL, Congress further amended the Higher Education Act to provide additional incentives for states to participate in the GSL program. It did so in part because the default rate was lower on loans insured by state agencies and because these agencies offered more support to lenders, students, and schools. The amendments authorized the payment of an administrative cost allowance to state agencies and provided both supplemental federal reinsurance of up to 100% of loan defaults and additional advance funds. In 1980, Congress created the PLUS program and authorized state guarantee agencies to undertake loan insurance and administrative functions similar to those they carried out for the GSL program.

By 1983, primarily as a result of the 1976 amendments, all states and eligible territories had established guarantee agencies. The FISL program was terminated in June of 1984 by the Department of Education on the grounds that it was no longer required by program lenders due to the ready availability of loan insurance through public or nonprofit guarantee agencies in all parts of the country.

[1/] The label "insurance premium" has been controversial, since premiums can be used for agency administrative expenses as well as to pay off default claims. Some agencies prefer to call it a "guarantee fee." We use the former term because it is the one used in federal law and regulations.

There are currently 58 agencies providing loan guarantees in the 50 states, the District of Columbia, and the territories. Thirteen of the agencies are operated by one of two large multistate nonprofit guarantee agencies: the Higher Education Assistance Foundation (HEAF) and United Student Aid Funds (USAF).

By the end of FY 1984, about $50 billion in GSL and PLUS loans had been guaranteed, 85% insured through guarantee agencies and the remainder through the FISL program. About $35 billion in loans were still outstanding at the end of FY 1984.

III. Sources and Uses of Funds by State Agencies

Guarantee agencies receive funds from the federal government (in the form of advance funds, administrative cost allowances, and reinsurance payments), from insurance premiums paid by program borrowers, from collections of defaulted loans, from interest on reserve funds, and from state appropriations. As shown in Table 1, in FY 1984 guarantee agencies received about $1.06 billion in income, of which about $896 million was used to support program operations. The other $166 million was added to agency reserves to pay for defaults not covered by federal reinsurance, for claims to lenders in advance of federal reimbursement, and for future administrative expenses.

Guarantee agency income more than doubled between FY 1982 and FY 1984 and total accumulated reserves grew by 55 percent, reflecting a rapid increase in new loan volume, loans outstanding, and loans coming into repayment. Though overall agency default rates remained approximately steady, the increase in loans at the repayment stage caused an increase in the dollar amount of loans in default and a consequent increase in agency expenditures for default claims and income received as reinsurance.

The remainder of this section describes the types of income received by guarantee agencies:

Federal Advance Funds

The federal government provides advances to guarantee agencies to establish reserves to pay for loan defaults. Advances were authorized by the Higher Education Act of 1965 and subsequent amendments in 1968 and 1976. Eleven agencies are still eligible to receive 1976 advances; agency eligibility for 1965 and 1968 advances has been exhausted.

As Table 2 shows, the federal government has paid about $144 million in advances, of which $23 million have been repaid and $121 million remain outstanding. Eighty-five percent ($103 million) of the outstanding advances are from 1976 funds. Ten agencies have repaid all of their advances, 6 agencies have repaid only their 1965 and 1968 advances, and one agency has repaid only its 1976 advances.

Table 1: Sources and Uses of Funds--Guarantee Agencies
(FY 1984 and FY 1982)
(dollars in millions)

Sources of Funds	FY 1984	FY 1982
A. Federal government		
o Advance Funds	$ 20.4	$ 4.1
o Administrative cost allowance	61.9	54.5
o Reinsurance	659.0	231.0
B. Insurance Premiums	123.5	104.4
C. Collections	122.3	49.6
D. Investment Income	59.4	49.4
E. State Appropriations	16.4	10.0
Total Sources of Funds	$1,062.9	$503.0

Uses of Funds	FY 1984	FY 1982
A. Operating expenses	$133.2	$ 95.9
B. Default claims	663.5	240.6
C. Collections[1/]	80.5	35.2
D. Other[2/]	19.3	10.0
Total Uses of Funds	$896.5	$381.7
Annual Excess or (Deficiency)	$166.4	$121.3
Total Reserves	$841.5	$542.1
Annual Loan Volume (in billions)	$7.9	$6.0
Loans in repayment (in billions)[3/]	$15.7	$7.3
Loans outstanding (in billions)[3/]	$34.7	$23.1

1/Portions of collection on loans in default returned to the U.S. Department of Education after allowance for agency collection costs.

2/Primarily includes the return of advance funds to the Department of Education and the return of state and other non-federal loans.

3/Original principal balance.

Table 2: Federal Advances Repaid and Currently Outstanding
(FY 1984)
(dollars in millions)

Agency	Advances Repaid			Advances Outstanding		
	1965 and 1968	1976	Total	1965 and 1968	1976	Total
Alabama	$ -	$ -	$ -	$ .4	$ 1.2	$ 1.6
Alaska	1/	.1	.1	-	-	-
Arkansas	.2	-	.2	-	.3	.3
California	-	-	-	2.6	11.8	14.4
Colorado	-	-	-	.2	5.6	5.8
Connecticut	-	-	-	-	3.9	3.9
Delaware	-	-	-	.1	.3	.4
Florida	-	-	-	.5	1.0	1.5
Georgia	-	-	-	.7	1.4	2.1
Idaho	-	-	-	-	.3	.3
Illinois	1.0	-	1.0	-	4.1	4.1
Indiana	-	-	-	.8	1.4	2.1
Iowa	-	-	-	.5	.9	1.3 2/
Kentucky	-	-	-	.6	.3	.8
Louisiana	-	-	-	.3	.7	1.0
Maine	.1	-	.1	-	.6	.6
Maryland	-	-	-	.3	.7	1.0
Massachusetts	.5	2.5	3.0	-	-	-
Michigan	-	-	-	1.3	2.8	4.1
Mississippi	-	-	-	.4	.2	.6
Missouri	-	-	-	.3	5.7	6.0
Montana	-	-	-	-	.7	.7
Nevada	-	-	-	1/	.2	.2
New Hampshire	.1	-	.1	-	.4	.4
New Jersey	-	-	-	.5	6.2	6.7
New Mexico	-	-	-	.1	.3	.4
New York	1.5	-	1.5	-	10.3	10.3
North Carolina	-	-	-	.6	.4	1.0
North Dakota	-	-	-	-	.2	.2
Ohio	-	-	-	.9	2.1	3.0
Oklahoma	-	-	-	.3	.4	.7
Oregon	.3	.8	1.1	-	-	-
Pennsylvania	1.8	-	1.8	-	13.9	13.9
Rhode Island	-	.9	.9	.1	-	.1
South Carolina	-	-	-	.2	.3	.5
South Dakota	-	-	-	.1	2.3	2.4
Tennessee	-	-	-	.6	.7	1.3
Texas	-	-	-	1.1	5.4	6.4
Utah	-	-	-	.2	1.2	1.4
Vermont	-	-	-	.1	.5	.6
Virginia	.3	1.8	2.1	-	-	-
Washington	-	-	-	.2	5.6	5.8
Wisconsin	-	-	-	.6	3.6	4.2

(continued)

Table 2: Federal Advances Repaid and Currently Outstanding
(FY 1984)
(dollars in millions)

Agency	Advances Repaid			Advances Outstanding		
	1965 and 1968	1976	Total	1965 and 1968	1976	Total
HEAF Agencies:[3]						
DC	-	.4	.4	-	-	-
Kansas	-	3.1	3.1	-	-	-
Minnesota	-	6.5	6.5	-	-	-
Nebraska	-	.7	.7	-	-	-
West Virginia	-	.1	.1	-	-	-
Wyoming	-	.1	.1	-	-	-
USAF Agencies:[4]						
USAF	-	-	-	3.2	-	3.2
Arizona	-	-	-	-	3.1	3.1
Hawaii	-	-	-	.1	1.0	1.1
American Samoa	-	-	-	-	.2	.2
Guam	-	-	-	-	.2	.2
Northern Marianas	-	-	-	-	.2	.2
Trust Territories	-	-	-	-	.2	.2
Others:						
Puerto Rico	-	-	-	.2	.2	.4
Virgin Islands	-	-	-	-	.3	.3
Total	$5.8	$17.0	$22.8	$18.0	$102.7	$120.7

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[1]/Less than .05.

[2]/In some cases, numbers do not add to totals due to rounding.

[3]/The Higher Education Assistance Foundation (HEAF) is multi-state guarantor that acts as the guarantor in 5 states and provides certain other targeted loan insurance programs.

[4]/The United Student Aid Funds (USAF) is multi-state guarantor that acts as a guarantor in 2 states and 4 Territories and provides certain other targeted loan insurance programs.

The Secretary of Education is empowered to recall 1965 and 1968 advances if he determines that they are no longer necessary to maintain an "adequate reserve." To date, this formal power has not been used, perhaps because no one has satisfactorily defined what constitutes an adequate reserve fund for individual agencies. Guarantee agencies need only return the portion of their 1976 advances that in any fiscal year exceeds 20 percent of their "insured loan portfolio," defined as the total amount of loans currently insured by a guarantee agency excluding principal repayments. This requirement is set by Congress rather than the Secretary of Education; to date it has not resulted in any agency being required to return its 1976 advances.

Federal Administrative Cost Allowances

The federal government provides two administrative cost allowances to guarantee agencies to pay for program operating expenses such as (1) promoting the participation of commerical lenders in the GSL program; (2) providing assistance to lenders for preventing defaults; (3) monitoring the enrollment and repayment status of program borrowers; (4) collecting on loans in default; and (5) other related costs.

Assuming adequate funds are appropriated by Congress, the primary and secondary allowances each equal one-half of one percent of the total principal amount of loans guaranteed during the fiscal year. They can only be used to pay for program operating expenses. Eligibility for the secondary allowance is limited to agencies that are eligible to receive supplemental reinsurance of loan defaults and that agree to insure loans for borrowers who are not legal residents of the state but who attend school in-state.

In FY 1984, the federal government paid about $62 million in administrative cost allowances to guarantee agencies, with all 58 agencies receiving the primary allowance and 49 agencies receiving the secondary allowance.

Federal Reinsurance

The federal governnment reinsures loans insured by guarantee agencies through two programs. The primary reinsurance program provides 80 percent reinsurance on loan defaults. The supplemental program gives agencies additional reinsurance up to 100 percent of loan defaults, depending on the agency's default record. Agencies are only eligible to receive supplemental reinsurance if they agree to insure loans for in-state residents attending out-of-state schools; all agencies currently do so.

Under the supplemental insurance program, the federal government provides 100 percent reinsurance of loan defaults for the first five years an agency is eligible for this program. Beginning with the sixth year, and continuing thereafter, the federal government provides 100 percent reinsurance for loan defaults equal to less than 5 percent of loans in repayment, 90 percent reinsurance for loan defaults over 5 percent of loans in repayment and less

than 9 percent, and 80 percent reinsurance for all defaults over 9 percent. The federal government defines the reinsurance ratio for any given fiscal year as the amount of loans entering default in that year divided by the total original principal balance of loans outstanding in repayment at the end of the previous fiscal year.

In FY 1984, the federal government reinsured 98.7 percent of the value of loans on which borrowers defaulted. As shown in Table 3, 43 agencies qualified for 100 percent reinsurance of all loans entering default, and all but two of the remaining agencies received at least 95 percent reinsurance.

Insurance Premium Income

The federal government allows guarantee agencies to charge borrowers an insurance premium equal to a maximum of 1 percent per year of the unpaid principal balance of the amount borrowed.[1/] Agencies may use insurance premiums to pay for loan defaults and (where state law permits) program operating expenses not covered by federal administrative cost allowances and reinsurance. Agencies set their own rates; Table 4 shows that the majority charge 1 percent per year for the in-school period and for either 6 months or one year in addition. Some states charge significantly less, with Alaska charging nothing at all.

Collections

The federal government allows agencies to retain up to 30 percent of collections they make on defaulted GSLs for which they have already received federal reinsurance. These funds can be used to pay for the administrative costs of collection and to provide assistance to lenders to prevent defaults. In FY 1984, guarantee agencies collected approximately $122 million in defaulted GSLs and retained about $42 million.[2/]

Investment Earnings

Agencies earn income on reserves. They use these investment earnings to pay for program operating expenses and loan default

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[1/] The federal government requires that agencies refund insurance premium fees to program borrowers if the loan is repaid in less time than projected by the agency. The refund provisions, however, only apply to agencies that charge fees based on a period longer than the projected in-school period plus 1 year.

[2/] Our statistics for 1984 show states keeping 34 percent of their collections, rather than 30 percent as suggested by the federal rule on retained funds. We believe that retained funds amount to more than 30 percent of total collections because agencies may keep all of the defaulted funds they collect that are not eligible for federal reinsurance.

Table 3: Federal Reinsurance of Guarantee Agency Loan Defaults
(FY 1984)
(dollars in millions)

Agency	Loans Entering Default	Total Federal Reinsurance	Average Percentage Reinsured
Alabama[1/]	$ 1.5	$ 1.5	100.0%
Alaska	0.1	0.1	100.0
Arkansas	0.8	0.8	100.0
California	66.8	62.4	93.4
Colorado[1/]	5.0	5.0	100.0
Connecticut	19.4	19.4	100.0
Delaware	0.5	0.5	100.0
Florida	16.5	15.8	95.6
Georgia	4.6	4.6	100.0
Idaho	1.2	1.2	100.0
Illinois	27.3	27.3	100.0
Indiana	4.0	4.0	100.0
Iowa	6.2	6.1	97.1
Kentucky	3.5	3.5	100.0
Louisiana[1/]	3.4	3.4	100.0
Maine	4.1	4.0	98.6
Maryland	12.6	12.0	95.5
Massachusetts	29.6	29.6	100.0
Michigan	25.2	24.8	98.4
Mississippi	0.8	0.8	100.0
Missouri[1/]	9.5	9.5	100.0
Montana[1/]	1.0	1.0	100.0
Nevada	1.1	1.1	96.4
New Hampshire	1.9	1.9	100.0
New Jersey	39.7	39.7	100.0
New Mexico	1.0	1.0	100.0
New York	133.6	133.5	99.9
North Carolina	2.6	2.6	100.0
North Dakota[1/]	0.4	0.4	100.0
Ohio	7.5	7.5	100.0
Oklahoma[1/]	4.9	4.9	100.0
Oregon	3.7	3.7	100.0
Pennsylvania	64.8	64.7	99.9
Rhode Island	4.0	4.0	99.9
South Carolina	0.2	0.2	100.0
South Dakota	2.5	2.5	100.0
Tennessee	2.8	2.8	100.0
Texas[1/]	6.5	6.5	100.0
Utah	3.1	3.1	100.0
Vermont	0.9	0.9	100.0
Virginia	9.3	9.3	100.0
Washington	3.5	3.5	100.0
Wisconsin	20.8	20.7	99.6

(continued)

Table 3: Federal Reinsurance of Loan Defaults
(FY 1984)
(dollars in millions)

Agency	Loans Entering Default	Total Federal Reinsurance	Average Percentage Reinsured
HEAF Agencies:			
DC[1/]	$ 11.6	$ 11.6	100.0%
Kansas	14.1	13.5	95.7
Minnesota	27.8	27.0	97.1
Nebraska[1/]	9.4	9.4	100.0
West Virginia[1/]	4.8	4.8	100.0
Wyoming[1/]	0.6	.6	100.0
USAF Agencies:			
USAF	11.8	11.5	97.2
Arizona[1/]	12.1	12.1	100.0
Hawaii[1/]	1.7	1.7	100.0
American Samoa[1/]	[2/]	[2/]	100.0
Guam[1/]	[2/]	[2/]	100.0
Northern Marianas	[2/]	[2/]	100.0
Trust Territories[1/]	.2	.2	100.0
Others:			
Puerto Rico	.1	.1	100.0
Virgin Islands	.2	.1	91.3
Total[3/]	$653.3	$644.6	98.7%

[1/] These agencies automatically qualify for 100 percent reinsurance of loan defaults under the 1976 provisions of the Higher Education Act. The 1976 act provides that agencies that meet the requirements for supplemental loan reinsurance receive 100 percent reinsurance of all loan defaults for five fiscal years regardless of their actual default rate.

[2/] Less than .05.

[3/] These totals do not match the totals in Table 1 because they come from a later, more accurate report provided to the authors by the Department of Education.

Table 4: Agency Insurance Premium Policies
(FY 1984)

Agency	Rate	Time-Period
Alabama	1%	In-School + 6 Months
Alaska	0	No charge
Arkansas	1%	In-School + 6 Months
California	1%	In-School + 1 Year
Colorado	1%	In-School + 6 Months
Connecticut	1%	Flat rate for 1 Year
Delaware	1/2%	In-School + 6 Months
Florida	1%	In-School + 6 Months
Georgia	1%	In-School + 6 Months
Idaho	1%	In-School + 1 Year
Illinois	1/2%	In-School + 6 Months
Indiana	1%	In-School + 6 Months
Iowa	3/4%	In-School + 10 Months
Kentucky	1%	In-School + 6 Months
Louisiana	1%	In-School + 1 Year
Maine	1%	In-School + 6 Months
Maryland	1%	In-School + 6 Months
Massachusetts	1/2%	In-School + 6 Months
Michigan	1%	In-School + 6 Months
Mississippi	1%	In-School + 1 Year
Missouri	1%	In-School + 6 Months
Montana	1%	In-School + 6 Months
Nevada	1%	In-School + 6 Months
New Hampshire	1%	In-School + 6 Months
New Mexico	1%	In-School + 1 Year
New Jersey	1%	Flat Rate for 1 Year
New York	1/4%	In-School + 6 Months
North Carolina	1%	In-School + 1 Year
North Dakota	1%	In-School + 1 Year
Ohio	1%	In-School + 6 Months
Oklahoma	1%	In-School + 6 Months
Oregon	1%	In-School + 6 Months
Pennsylvania	1/2%	In-School + 6 Months
Rhode Island	3/4%	In-School + 6 Months
South Carolina	3/4%	In-School + 1 Year
South Dakota	1%	In-School + 1 Year
Tennessee	3/5%	In-School + 6 Months
Texas	1%	In-School + 1 Year
Utah	1%	In-School + 6 Months
Vermont	1%	In-School + 6 Months
Virginia	1/2%	In-School + 1 Year
Washington	1%	In-School + 6 Months
Wisconsin	1%	In-School + 6 Months

(continued)

Table 4: Agency Insurance Premium Policies
(FY 1984)

Agency	Rate	Time-Period
HEAF Agencies:		
DC	3/4%	In-School + 6 Months
Kansas	3/4%	In-School + 6 Months
Minnesota	3/4%	In-School + 6 Months
Nebraska	3/4%	In-School + 6 Months
West Virginia	3/4%	In-School + 6 Months
Wyoming	3/4%	In-School + 6 Months
USAF Agencies:		
USAF	3/4%	In-School + 6 Months
Arizona	3/4%	In-School + 6 Months
Hawaii	3/4%	In-School + 6 Months
American Samoa	3/4%	In-School + 6 Months
Guam	3/4%	In-School + 6 Months
Northern Marianas	3/4%	In-School + 6 Months
Trust Territories	3/4%	In-School + 6 Months
Others:		
Puerto Rico	n/a[1/]	n/a
Virgin Islands	n/a	n/a

[1/] n/a = not available

Source: National Council of Higher Education Loan Programs, State Agency Survey: Guaranteed Education Loan Programs, 1984, prepared by the New York State Higher Education Services Corporation, May 1985.

costs and/or retain them to pay future expenses. Agencies that have returned their 1965 and 1968 advances, however, are free to use their investment earnings (except for earnings on their 1976 advances) as they wish, within the limits of state law. In FY 1984, investment earnings totaled almost $60 million.

State Appropriations

State appropriations are primarily made to guarantee agencies to pay for operating expenses and defaults. In FY 1984, 19 agencies received about $13.3 million in state appropriations for these purposes. In addition, two agencies (in Georgia and Maryland) received $3.1 million in state appropriations to make supplemental lenders incentive payments. These annual figures understate the state contribution somewhat, since agencies may have received state funds in earlier years to use for reserves, the earnings on which appear in 1984 in the "investment earnings" category.

IV. The Adequacy of Agency Reserve Funds

Guarantee agencies hold reserve funds to cover loan defaults and other future expenses that might exceed future income. Lenders and holders of student loan bonds, in particular, are concerned that agencies have sufficient reserves to pay for defaults that are not covered by federal reinsurance. These potential obligations stretch far into the future; agencies are liable for default claims until a loan is completely repaid, which can be 15 or more years after it was made. Without confidence that adequate reserves are and will continue to be available, lenders would be reluctant to participate in the program and bond rating firms would lower their ratings on GSL bonds, both discouraging bond purchasers and raising costs to the issuing organizations.

Guarantee agencies are not required by the federal government to hold any particular level of reserves. They may set reserve requirements as a matter of agency policy or as the result of either state law or contractual agreements with lenders. According to a survey by the National Council of Higher Education Loan Programs (NCHELP),[1/] some agencies have no stated reserve requirements and those that do range widely, from one percent to as much as 10 percent of the original principal balance of loans outstanding.

Data do not exist on the exact funds held by each agency to meet future default obligations. The closest proxy available is the statistic representing total reserves that is reported on the Sources and Uses of Funds Report. While this number cannot be definitive, it is at least suggestive of the amounts state agencies have accumulated to meet future needs, by far the largest of which is default payments. Table 5 shows total reserves by agency, along with the amount of these reserves that represent advance funds not

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1/NCHELP, State Agency Survey: Guaranteed Education Loan Programs, 1984, prepared by the New York State Higher Education Services Corporation, May 1985.

yet repaid to the federal government, total loans outstanding,[1] and the ratio of net reserves (total reserves less advance funds) to total loans outstanding.

Deciding whether states can return their outstanding federal advances, and more generally whether they are holding adequate or inadequate reserves to pay future obligations, must be determined in light of not only the current system of federal reinsurance but the fact that agencies may have to protect themselves against possible future changes in that system.

Reinsurance and Reserves

Under the current system of primary and supplemental federal reinsurance for GSLs, all guarantee agencies receive reinsurance equal to 80 percent of their loan default claims accepted by the Department of Education. Their liability should therefore be limited to whatever proportion of the remaining 20 percent of defaults is not covered by supplemental reinsurance, a proportion that varies depending on each agency's default rate but is now zero for most (see Table 3).

Even if primary and secondary reinsurance policies remain just as they are, however, an agency cannot assume that it will continue to receive the same level of reinsurance that it currently does, and must accumulate reserves accordingly. The proportion of GSLs going into default in the future might rise, thus reducing the amount of reinsurance it qualifies for. This could happen because the general tendency of borrowers to default increases; indeed, the Department of Education has recently announced that it expects the GSL default rate to rise in 1985. It could also happen, however, even if this underlying default rate remains the same, if loan volume increases rapidly relative to past borrowing. About half of all borrowers who default do so early in repayment. If a comparatively large volume of loans comes into repayment at one time, relative to past volume, the amount of loans coming into default will increase compared to the total of loans outstanding in repayment. This will cause an agency's reinsurance ratio to fall, at least temporarily.

The relationship between an agency's default rate and its reinsurance ratio is a complicated one, but for the purpose of making an initial assessment of the adequacy of reserves against default we can create an illustrative hypothetical standard. Under current program rules, we can say that an agency needs to keep a reserve fund equal to the national default rate (roughly 10 percent in 1984) times the proportion of loan defaults not covered by primary federal reinsurance (20 percent). This formula suggests that an agency's maximum liability for loan defaults would be 2 percent of loans outstanding, assuming its default rate does not significantly exceed the national average.

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[1] Actually, the original principal balance of loans that have not yet been repaid in full.

Table 5: Net Reserves (Total Reserves Less Advances) as a Percent of Loans Outstanding (FY 1984)

Agency (year established)		Total Reserves (in millions)	Advances Outstanding (in millions)	Loans Outstanding (in millions)	Net Reserves as a Percent of Loans Outstanding
Alabama	(1981)	$ 2.3	$1.6	$ 154.0	.5%
Alaska	(1972)	.2	-	18.2	1.2[1/]
Arkansas	(1967)	6.2	.3	131.9	4.5
California	(1967)	57.7	14.4	2,471.8	1.8
Colorado	(1980)	13.5	5.8	379.4	2.0
Connecticut	(1966)	12.0	3.9	1,207.5	.7
Delaware	(1966)	4.3	.4	105.6	3.6
Florida	(1979)	12.3	1.5	724.3	1.5
Georgia	(1965)	13.5	2.1	332.0	3.4
Idaho	(1979)	1.5	.3	77.6	1.7
Illinois	(1965)	26.4	4.1	2,079.4	1.1
Indiana	(1978)	12.8	2.1	599.6	1.8
Iowa	(1979)	19.2	1.3	501.3	3.6
Kentucky	(1978)	7.8	.8	307.4	2.3
Louisiana	(1964)	4.0	1.0	286.0	1.0
Maine	(1968)	8.5	.6	224.0	3.5
Maryland	(1965)	29.2	1.0	544.0	5.2
Massachusetts	(1966)	43.6	-	1,832.4	2.4[1/]
Michigan	(1962)	38.5	4.1	1,184.1	2.9
Mississippi	(1982)	2.0	.5	88.3	1.7
Missouri	(1968)	16.5	6.0	467.3	2.2
Montana	(1980)	2.4	.7	78.6	2.1
Nevada	(1970)	1.9	.2	56.9	3.0
New Hampshire	(1965)	4.4	.4	188.6	2.1
New Jersey	(1960)	34.8	6.7	1,879.4	1.5
New Mexico	(1981)	2.3	.4	92.6	2.1
New York	(1958)	100.1	10.3	5,644.1	1.6
North Carolina	(1966)	13.4	1.0	234.4	5.3
North Dakota	(1982)	4.9	.2	79.8	5.9
Ohio	(1962)	46.5	3.0	1,443.9	3.0
Oklahoma	(1966)	5.6	.7	171.0	2.9
Oregon	(1967)	8.0	-	307.8	2.6[1/]
Pennsylvania	(1967)	77.9	13.9	3,221.3	2.0
Rhode Island	(1959)	8.9	.1	239.8	3.7
South Carolina	(1978)	2.5	.5	61.6	3.3
South Dakota	(1979)	8.5	2.4	230.2	2.7
Tennessee	(1963)	9.1	1.3	377.3	2.1
Texas	(1981)	13.1	6.4	585.3	1.1
Utah	(1978)	8.8	1.4	198.5	3.7
Vermont	(1965)	2.0	.6	126.9	1.1
Virginia	(1961)	29.2	-	602.7	4.8[1/]
Washington	(1979)	6.4	5.8	344.0	.2
Wisconsin	(1967)	28.0	4.2	1,068.1	2.2

(continued)

Table 5: Net Reserves (Total Reserves Less Advances) as a Percent of Loans Outstanding (FY 1984)

Agency (year established)		Total Reserves (in millions)	Advances Outstanding (in millions)	Loans Outstanding (in millions)	Net Reserves as a Percent of Loans Outstanding
HEAF Agencies:					
DC	(1981)	$ 8.7	-	$ 258.4	3.4%[1]
Kansas	(1978)	13.4	-	463.5	2.9[1]
Minnesota	(1977)	37.7	-	1,349.4	2.8[1]
Nebraska	(1981)	10.0	-	322.9	3.1[1]
West Virginia	(1981)	4.8	-	188.5	2.5[1]
Wyoming	(1981)	1.0	-	40.5	2.4[1]
USAF Agencies:					
USAF	(1960)	5.2	3.3	679.5	.3
Arizona	(1981)	4.4	3.1	262.8	.5
Hawaii	(1980)	2.2	1.1	75.7	1.5
American Samoa	(1982)	.1	.2	.3	[3]
Guam	(1982)	.1	.2	1.2	[3]
Northern Marianas	(1982)	.1	.2	.2	[3]
Trust Territories	(1982)	.2	.2	4.0	
Others:					
Puerto Rico	(1981)	3.3	.4	103.6	2.8
Virgin Islands	(1978)	n/a	.3	n/a[2]	n/a
Total		$841.5	$120.7	$34,698.8	2.1%

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[1] All advances have been repaid.

[2] n/a = not available

[3] In very small agencies, the relationship between reserves and advances can be distorted by variations in other parts of the financial statement; in particular, it can be affected by accounts receivable that exceed accounts payable.

Table 5 indicates that, under this hypothetical scenario, 22 agencies would have less than a 2 percent reserve fund if they returned their federal advances, including one that has already repaid its advances. (Fifteen of these agencies currently have less than a 2 percent reserve fund even counting their advances.) A different and probably more realistic scenario might assume that states would never lose their eligibility for supplemental insurance entirely and that therefore they only need a 1 percent reserve fund, sufficient to cover defaults of 10 percent if there were 90 percent reinsurance (still far below current reinsurance ratios for almost all agencies). In this situation only 9 agencies could not meet the standard if they returned their advances. Seven of these are fairly new and could be protected from a requirement to return advances for some period of time. Some similar transition arrangement could be made for the other two agencies as well if they felt they needed it.

Uncertainty

The problem with the foregoing analysis is that it does not account for uncertainty. State agencies cannot count on default rates remaining unchanged, nor can they count on the federal government to continue the present system of primary and supplemental reinsurance. For example, the Reagan Administration proposed in its FY 1986 budget to reduce the rate of loan insurance from the current 80 to 100 percent of defaults to a rate ranging between 50 and 90 percent of loan defaults. Had such a provision been enacted, agencies might have felt it necessary to hold 5 percent reserve funds (10 percent default rate times a maximum liability on 50 percent of defaults) or even higher if they wanted to protect against an increase in the default rate. Viewed in this light, the wide range in reserve requirements (from 1 to 10 percent as noted on p. 14) is more readily understood.

One final aspect of uncertainty involves the issue of timeliness of federal reinsurance payments. Unless a guarantee agency can count on prompt payment of reinsurance by the federal government (which it has not always been able to do), it could run into cash flow problems unless it has sufficient reserve funds to carry the unpaid obligation until federal reimbursement is received.

Conclusions

If guarantors could count on current reinsurance provisions remaining in force and if default rates don't skyrocket, it appears that most agencies could repay their federal advances without great difficulty and that the others could be protected for a transition period while they built up their reserves to adequate levels. In the absence of a stable reinsurance system, however, agencies will probably feel the need to hold higher reserves than would be otherwise the case. If they were required to return advances only if their reserve funds exceeded 2.5 percent of loans outstanding, the federal government would recapture only $20 million of the $121 million in outstanding advances. If the trigger level for repayment of advances were raised to 3.5 percent, the federal government would recapture only $6 million.

Apart from the question of whether agencies can afford to repay advances is the issue of whether some may be holding more reserves than they need, raising the possibility that insurance premiums to student borrowers might be reduced. Three agencies have ratios of net reserves (excluding advances) to loans outstanding of more than 5 percent; 13 more have ratios between 3 and 5 percent. A permanent reinsurance system or some cap on the maximum liability agencies face for defaults might allow these agencies to reduce fees charged to borrowers.

Determining an appropriate level for agency reserves would be facilitated if, along with stabilizing the reinsurance system, a way could be found to measure the unpaid principal of loans outstanding instead of relying on the original principal balance. Only the latter figure is readily available to guarantee agencies at present. Using it, however, as they must in the absence of a better indicator, may contribute to a tendency for some agencies to hold large reserves.

Any consideration of requirements that agencies return advance funds or of changes that might lead to a cap on the amount of reserve funds an agency holds must allow agencies time to adjust. As noted above, some might need a transition period to build their reserves up if they lost advances, while others might not be able to lower their reserve holdings until state reserve requirements were changed or lender agreements renegotiated.

Finally, it must be recognized that the question of what constitutes adequate or inadequate reserves, while most importantly related to agencies' liability for loan defaults, is also connected to present and future operating expenses, an issue pursued more fully in the following section. Though federal advance funds themselves can only be used to meet default obligations, income on these reserves can be used to offset administrative expenses. Moreover, agencies may feel that they need to accumulate some reserves specifically to protect themselves against the future costs of administering loans they are making now, especially if other sources of operating revenue (such as federal administrative cost allowances or state appropriations) are uncertain. With these concerns in mind, we turn to the issue of the adequacy of agency operating funds and whether agencies can afford to lose the annual ACA payments they receive from Washington.

V. The Adequacy of Agency Operating Funds

In FY 1984 guarantee agencies reported spending about $133 million on costs of operation, including the costs of collecting on defaulted loans. They were allowed to keep $42 million of the defaults on which they collected and also received $62 million in administrative cost allowances (ACAs) from the federal government. The ACAs amounted to 46 percent of agency operating expenses overall, in 1984; Table 6 shows that for individual agencies the ratio of ACA to operating expenses averaged over a three year period varied widely.

Table 6: Federal ACA Payments Compared to Operating Expenses and Annual Surpluses

	ACA as a % of Operating Expenses 1982-1984	ACA as a % of Annual Surplus 1984	ACA as a % of Annual Surpluses 1982-1984
Alabama	41.6	79.0%	62.0%
Alaska	44.1	1/	1/
Arkansas	26.3	27.8	18.8
California	64.3	12.4	46.0
Colorado	46.2	19.2	29.3
Connecticut	43.7	1/	1569.4
Delaware	42.4	30.4	46.3
Florida	58.7	1/	144.7
Georgia	27.5	71.3	55.6
Idaho	45.5	28.1	54.5
Illinois	48.0	42.8	34.5
Indiana	2/	59.2	2/
Iowa	62.4	23.9	22.4
Kentucky	62.4	40.9	78.7
Louisiana	45.3	31.2	53.2
Maine	43.6	14.2	46.7
Maryland	2/	2/	2/
Massachusetts	51.1	734.7 4/	87.0
Michigan	79.1	11.6	19.4
Mississippi	2/	72.6	2/
Missouri	61.7	30.2	40.5
Montana	62.0	36.2	36.5
Nevada	45.2	33.7	49.9
New Hampshire	40.1	103.3	53.3
New Jersey	44.7	169.5	108.6
New Mexico	30.7	36.6	21.1
New York	45.8	31.4	46.9
North Carolina	52.2	10.8	10.6
North Dakota	2/	20.1	2/
Ohio	61.0	35.4	34.4
Oklahoma	36.0	1/	95.1
Oregon	41.8	27.8	49.2
Pennsylvania	39.8	74.3	221.6
Rhode Island	33.3	1/	92.9
South Carolina	59.4	13.1	10.8
South Dakota	45.9	23.7	25.7
Tennessee	71.1	15.3	18.8
Texas	52.7	48.5	51.8
Utah	44.1	13.7	24.8
Vermont	27.9	188.7	115.3
Virginia	34.1	45.2	17.7
Washington	35.8	56.6	102.5
Wisconsin	54.7	37.2	46.1

(continued)

Table 6: Federal ACA Payments Compared to Operating Expenses and Annual Surpluses

	ACA as a % of Operating Expenses 1982-1984	ACA as a % of Annual Surplus 1984	ACA as a % of Annual Surpluses 1982-1984
HEAF Agencies:			
DC	81.1	39.7	42.1
Kansas	71.9	45.5	47.1
Minnesota	55.1	29.4	35.6
Nebraska	79.6	41.5	40.9
West Virginia	83.5	57.5	47.4
Wyoming	58.3	48.2	40.0
USAF Agencies:			
USAF	41.8	169.1	1/
Arizona	68.0	314.1	134.5
Hawaii	50.6	33.9	58.5
American Samoa	2/	1.9	2/
Guam	2/	11.3	2/
Northern Marianas	2/	1.8	2/
Trust Territories	2/	1050.0	2/
Others:			
Puerto Rico	67.3	116.7	25.8
Virgin Islands	n/a3/	n/a3/	n/a3/
Total	49.2	37.2	48.7

1/The agency had a deficit rather than a surplus for the period in question.

2/The agency reported no ACA payments for at least one of the years in question, an apparent error in the Sources and Uses of Funds Report.

3/Not available

4/The Massachusetts agency repaid all of its advance funds in FY 1984, resulting in an unusually small annual surplus for that year and thus exaggerating the ratio of ACA to surplus.

The Reagan Administration has already tried to eliminate ACAs by refusing to make any payments due after October 1, 1984, though Congress has refused to ratify this change and the status of the payments is still in doubt. A number of agencies have protested about either the suddenness and retroactive nature of the Administration action, giving them no time to provide replacement funds in an orderly fashion, or about their general lack of other resources to make up for the loss of ACAs. Analysis of data from the Sources and Uses of Funds Report supports the contention that loss of ACAs may create serious problems for some agencies.

The Loss of ACAs

Table 6 shows not only the proportion of agency operating expenses met by ACAs but also how ACAs compare to the annual "bottom line" on the Sources and Uses of Funds Report: the excess or deficiency of sources over uses. For shorthand purposes, we will refer to this gap as an annual surplus or deficit.[1/] If agencies have sufficiently high annual surpluses, it might be argued that they could live without federal ACA payments.

As Table 6 makes clear, however, not all agencies have sufficient annual revenues to cover the loss of ACA payments. In FY 1984, 13 agencies received ACA payments higher than the annual surpluses they accumulated that year. (In fact, five of the eight did not have surpluses at all, but rather showed deficits for the year.) Looking at a three year period from 1982-1984, to smooth out unusual year-to-year variations, still indicates that nine agencies had higher ACAs than they did surplus revenues.

Moreover, one cannot conclude that agencies can afford to do without ACAs by looking at that change in isolation. It is important to consider the interactive effect on agencies of losing the ACA and also being required to return advance funds, since the latter will affect an agency's need to use some or all of any annual surplus revenues to replenish its reserves against default.

Considering ACAs and Advances Together

To see what would happen to agency finances if new rules were simultaneously adopted eliminating ACAs and requiring that advance funds be

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[1/] This does not correspond to the terminology most likely to be found on agency financial statements. The difference between revenues and expenditures on those statements is frequently referred to as "excess or deficiency" rather than "surplus or deficit;" and agencies using accrual accounting would be expected to set aside a portion of current income to meet the future costs of loans being made now. The Sources and Uses of Funds Report, by contrast, does not specifically account in its itemization of annual "uses of funds" for funds to be set aside for future needs Thus, what we call a "surplus" is not meant to suggest unneeded or uncommitted funds.

returned, we created four simple models. They were not meant to suggest actual policy changes so much as to test for possibilities and problems.

The first two models were designed to examine whether agencies had sufficient surplus revenues in fiscal year 1984 to set aside a reasonable amount for reserves and also cover the loss of ACA's. The formulas used in the calculations were:

Model 1 = 1984 surplus revenues minus 2% of 1984 loan volume set aside for reserves minus 1984 ACA

Model 2 = 1984 surplus revenues minus 1% of 1984 loan volume set aside for reserves minus 1984 ACA

If the results of these calculations were negative, we concluded that the agencies involved would have had financial difficulty if they had lost 1984 ACAs and had to depend on annual revenues to cover the loss.

Under Model 1, 39 agencies would have been "in trouble." Lowering the reserve set-aside to 1 percent in Model 2 (which many agencies would consider too low, for reasons noted above) only reduces this number by 16, leaving 23 agencies "in trouble." Losing advance funds as well seems to exacerbate the problem. Seventeen of the 39 agencies "in trouble" under Model 1 would have had less than 2 percent in net reserves in 1984 if advance funds had also been recalled. Under Model 2, 6 of the 23 agencies "in trouble" would have had less than 1 percent in net reserves.

In Model 3 and 4 we attempted to measure directly the impact of losing both ACAs and advances and also take account of the fact that some agencies have comparatively large net reserve funds which might be drawn down to help agencies cope with the loss of ACAs. The models assume that agencies need to keep either a 2 percent or a 1 percent net reserve fund and that excess reserves above these levels could be used over a five year period if necessary to cover the loss of ACAs. Thus:

Model 3 = (Net reserves minus 2% of loans outstanding) divided by 5 minus 1984 ACA

Model 4 = (Net reserves minus 1% of loans outstanding) divided by 5 minus 1984 ACA.

Again, if the results of these calculations were negative we concluded that the agency would not have had sufficient reserves to cover the loss of ACA payments in 1984.

Under these two new models, 41 and 28 agencies respectively would have been "in trouble," i.e., without sufficient reserves to cover the loss of ACAs. Neither size nor age appeared to be major determinants of which agencies had insufficient net reserve funds to cover the loss of ACAs.

An obvious question about these results is whether agencies "in trouble" under the various scenarios sketched out by Models 1 through 4 have other resources they could tap to alleviate the effects of losing advance funds and ACAs. Increasing insurance premiums and/or reducing operating expenses come immediately to mind. The Sources and Uses of Funds Report does not provide much information on the latter, but it is our impression that relative operating expenses do not bear much relationship to which agencies appear "in trouble" in our models and which do not. (We do not address the question of whether some agencies operate more efficiently than others, a subject that is beyond the scope of this analysis, but which bears investigating in light of sizable variation in operating expenses even when size and age of agency are taken into account.) Some agencies charge comparatively low insurance premiums and might be able to boost them somewhat. But it appears that some agencies (the exact number is hard to determine: we would guess perhaps 5 to 10) would have few options other than raising fees to students above the maximum currently being charged anywhere if they lost their federal subsidies for reserves and operating expenses. This number would be higher if we took account of the loss of investment income that agencies would experience if federal advances were recalled, a loss not reflected in our four simple models.

Conclusions

Elimination of the ACA appears more problematic for guarantee agencies than a requirement that they return federal advances, expecially if the latter change is also made. Some would seem to have no choice but to raise fees to students. Others would probably do so rather than tap into what might appear as excess reserves, in the absence of defined standard for reserves and limited agency liability for defaults. In this context, it is important to remember that student borrowers already pay a 5 percent "loan origination fee" on top of whatever insurance premiums agencies charge, with the combined total for freshman students in four year programs often approaching 10 percent of the amount borrowed.

IV. Concluding Remarks

The question of whether state-based guarantee agencies, the federal government's chosen instruments for administering guaranteed student loans, can afford to lose federal subsidies is a complicated one. Each state's particular circumstances determine the extent to which the pattern of federal subsidies created over a 20-year period initially influenced or continue to influence its willingness to undertake and maintain the guarantee function. Complicating the task of assessing the importance of federal subsidies are (1) the absence of reliable, comparable financial statistics for state agencies; (2) the absence of standards or guidelines for important elements of the financing structure such as reserve funds; and (3) the possibility that major features of the system might change at any point.

The available data suggest, however, that simultaneous changes recalling all advances and eliminating ACA payments would create financial problems for many agencies, problems that would be exacerbated if reinsurance were also subject to revision. As a one-time cost-saving measure, though, the federal government probably could recall all advance funds without serious effects on agency operations, if transition or alternative arrangements were made for a few (mostly new) agencies that could demonstrate real hardship from the loss of these funds.

While our analysis is not sufficient to determine what other subsidy changes agencies could absorb, it does suggest that the following guidelines could maximize the chances of finding federal cost savings without crippling the crucial functions performed by state agencies in the current GSL system:

-- agencies need time to adjust to proposed changes;

-- changes in reinsurance should only affect new loans; as long as they face any threat to reinsurance of old loans agencies can reasonably argue for high levels of reserve funds;

-- standards or guidelines for reserve funds (perhaps distinguishing between reserves against default and reserves against future operating expenses) would make it possible to distinguish "excessive" from "reasonable" reserves and to determine if students are paying appropriate insurance premiums;

-- a requirement that reserve calculations be based on the unpaid principal, rather than the original principal balance, of loans outstanding would reduce the need for reserve funds, if the requisite data could be collected without unreasonable cost; and

-- better, more comparable, and more public financial information would ease the task of assessing agency financing and encourage scrutiny of agencies whose operations seem particularly efficient or inefficient, making it possible not only to make more informed judgments about the need for ACAs but to identify cost-saving agency practices that should be widely adopted.